CFO Capital Management 2019 Third Quarter Update

The third quarter [Q-3] of 2019 brought on renewed easing by the global central banks. With the U.S. Federal Reserve leading the way by cutting our short-term, Federal Funds interest rate twice during Q-3, the accommodative global monetary policies have continued to boost most all asset class returns for 2019. All the major benchmark indices that we follow have risen at least +5% through the end of Q-3 as the table below shows. We briefly summarize the key takeaways:

- Bond prices surged in Q-3 and beat stocks for the quarter. The Barclay's Long-Term Treasury Bond Index was the top asset class, with a whopping +7.9% return for Q-3 as the 10-year Treasury yield fell as low as 1.47% in August before bouncing sharply to close Q-3 at 1.68%. The $13 trillion in ***negative*** yielding bonds globally, along with mounting evidence of sluggish global economic growth, combined to lower Treasury yields. The U.S. Aggregate Bond Index, our principle fixed income benchmark index, also posted a strong quarterly gain of +2.3%.
- The S&P 500 Index of U.S. stocks rose a meager +1.2% in Q-3, but continued its best start since 1997 with a 2019 year-to-date [YTD] return of +18.7%. The U.S. stock market continued its 2019 dominance over foreign stock markets as the MSCI EAFE Index of foreign stocks declined -1.1% in U.S. dollar terms during Q-3, and the MSCI Emerging Markets stock index declined by -4.1% as well.
- The Q-3 "flight-to-safety" theme was further evident in the rise of both gold [+4.0%] and the U.S. dollar [+3.3%] during the quarter.
- While the S&P GSCI is up +8.6% for 2019 YTD, the commodity index was driven -4.2% lower during Q-3 by the -8.2% quarterly decline in crude oil prices.

Index Returns for Asset Classes & Broad Market Index Averages (1)	3rd Quarter 2019	2019 YTD
30-Day US Treasury Bills	0.53%	1.69%
Barclays Long-Term US Treasury Bond	7.92%	19.77%
Barclays US Aggregate Bond Index	2.27%	8.52%
S & P 500 Composite Price Index	1.19%	18.74%
Dow Jones Industrials Price Index	1.19%	15.93%
Wilshire 5000 Total US Stock Mkt Index	0.73%	18.36%
MSCI EAFE Index of Foreign Markets	-1.07%	12.80%
MSCI Emerging Markets Index	-4.11%	6.23%
MSCI Europe Index	-1.80%	13.72%
MSCI Japan Index	3.13%	11.12%
MSCI China Index	-4.73%	7.62%
CFO Global Balanced Index	1.09%	12.98%
CFO Global Income Index	1.31%	10.46%
S & P GSCI (Commodity) Index	-4.18%	8.61%

(1) Source: MORNINGSTAR

While the **2019 YTD** returns of just under +20% for the S&P 500 and DJ Industrial Average are very strong, they mask the reality that the U.S. stock market has been relatively flat **over the past 12 months**. The S&P 500 and the DJ Industrial Average provided meager total returns of +2.1% and +1.7% respectively over the last year, while both the MSCI EAFE and EM Indices of foreign stocks declined slightly. During this same time period, however, the U.S. Aggregate Bond Index has returned +10.3%. These figures underscore two key points. First, within an environment of a slowing global economy, sector allocation has been important for both equities and fixed income. Second, individual manager and security selection have been critical to performance.

Our 2019 Fourth Quarter Macro-Economic Outlook

As we enter the fourth quarter [Q-4] of 2019, the U.S. economy continues to plod along at close to a +2% annual rate of growth. The household sector remains a pillar of strength, with growth in employment exceeding growth in the labor force. The economic expansion is now in its eleventh year, which is the longest in history, and inflation expectations remain well contained around 2%. Our economic outlook from the consensus of macro-economic research that we follow including Ned Davis Research [NDR], PIMCO, Fidelity, and other sources is that the U.S. economy is in late cycle, but the probability for recession in the next six to nine months still remains low. However, there are very real risks beginning with the fact that the global economy is in a sustained slowdown with economic growth decelerating in nearly 90% of the world including the U.S. and with most central banks pursuing what appears to be a perpetual state of ease. The Conference Board's Leading Economic Index [LEI] slipped -0.1% in September, which is down for the second straight month and is below the consensus for an unchanged reading. Half of the LEI's ten components declined. Several other leading indicators for the U.S. economy are also heading in the wrong direction. Following a -3.0% reported decline for August 2019, the Cass Freight Shipments Index, a measure of trucking transportation in the U.S., declined another -3.4% in September. Over the last four months of 2019, this shipments index has moved from [to quote] "***warning of a potential slowdown***" to "***signaling an economic contraction***."

It is also important to further point out that survey data [known as "soft" data] often leads the "hard" economic data. There are two examples that do not provide encouraging support of the current economic outlook. First, there is the Institute for Supply Management's [ISM] closely watched Purchasing Managers Index [PMI] that slipped into contraction territory in August before rebounding slightly to a neutral reading in September. Moreover, a recurring theme in manager comments in the most recent PMI reports has been concern about the still to be felt effects of tariffs already in place and soon to go into effect. Second, in addition to the ISM survey data that is negative for profits and exports, the most recent surveys of CEO confidence have shown a material loss in confidence, and there is a strong connection between falling CEO confidence and declining capital investment for equipment. In addition to CEO and business managers' confidence, there are those major, ongoing risks that ultimately impact the confidence levels of consumers and investors which also drive economic and financial market performance. In addition to a weak global economy, those well-known risks include trade issues as well as the broader domestic and global political dysfunction in both Europe [Brexit] and the U.S. [Impeachment proceedings]. Collectively, these risks/ concerns appear to be having an eroding impact on business, consumer and investor confidence. The most significant – and persistent - of these risk factors is the potential for the current trade disputes between the U.S. and its major trading partners to escalate and lead to deeper and more prolonged trade battles that would further weaken U.S. and global growth. While trade issues extend to Europe as well, the most visible - and the most dangerous - is the China-U.S. trade dispute. To be sure, U.S./China tensions are not just about strategic competitiveness, but national security as well. The bad news is that the fundamental trade issues between the U.S. and China aren't likely to be resolved any time soon. And the longer the dispute goes on, the more economic damage it appears to be causing. The only good news is that China and the U.S. are still talking, and may be edging toward a modest, partial agreement.

Our Financial Market Outlook and Investment Implications

Against this ongoing backdrop of political and economic uncertainty, the U.S. and global economies will most likely remain in a low-growth environment that will persist well into 2020 with elevated risk about whether the intervening passage of time will lead to recession or economic recovery. On the positive side, the Federal Reserve seems appropriately data-dependent and should cut the Federal Funds rate at least one more time this year, most likely in December. The Fed has also begun to boost its balance sheet at an initial pace of $60 billion per month to reduce market volatility linked to repurchase agreements (repos). Not to be confused with "quantitative easing," this Fed policy measure focuses on the purchase of Treasury bills, which targets short-term financial market needs for liquidity, while also providing for a moderate yield curve steepening and indirect support for risk assets.

When the current 10-year U.S. Treasury yield is compared to the yield on the S&P 500 Index of U.S. stocks, the 10-year Treasuries appear expensive, but the notes also appear over-priced when compared to inflationary expectations. A survey of economists, as recently reported on Bloomberg, provided a consensus forecast of 2.0% and 2.1% for the Consumer Price Index (CPI) for 2020 and 2021 respectively. With the yield on the 10-year U.S. Treasury currently at 1.8%, investors are getting a negative real rate of return for holding the 10-year Treasury. As we wrote earlier in our report, the $13 trillion in negative yielding global bonds have helped to drive 10-year Treasury yields artificially lower.

As we enter the earnings reporting period for Q-3 of 2019, U.S. stock prices appear reasonably priced with a 1.9% dividend yield when compared to the 1.8% 10-year Treasury yield. Also, the American Association of Individual Investors (AAII) reported last week that bullish sentiment -- a contrary [or positive] indicator for stock prices -- dropped to 20%, the lowest level since May 2016. Corporate earnings are still holding up moderately well with Wall Street strategists forecasting a small -3% year-over-year drop in third quarter corporate earnings. However, the consensus forecast for a +10% rise in earnings over the next year seems optimistic. Overly exuberant analysts notwithstanding, the continued accommodative Fed policy should help to support future stock prices.

The "bottom line" question for investors remains: When will this current period of consolidation resolve itself and in which direction are the financial markets headed over the balance of 2019 and into 2020. Going into the end of the year seasonal forces are a positive, but for the stock markets to breakout to the **upside**, we also need the following to happen: [1] There needs to at least be a constructive, albeit partial, trade deal between China and the U.S. that would boost consumer and business confidence and spending; [2] U.S. and global PMI data need to provide evidence of a sustainable economic turnaround; and [3] Global bond yields need to stop falling and recover [gradually] to rational, non-negative levels. The potential catalysts for a negative breakout to the **downside** are: [1] More signs of growing weakness across a broad spectrum of economic data that indicate a U.S. recession is becoming more likely and more imminent; [2] Any further escalation of the global trade war. Tensions have eased slightly following the recent announcement of a partial [but constructive] trade deal between China and the U.S. If this verbal agreement is not formally signed by the World Economic Forum in November, the recent slump in manufacturing and capex is likely to intensify and the probability for recession to increase; [3] Corporate earnings that broadly surprise on the negative side. Following the estimated small decline in Q-3, analysts are expecting corporate earnings growth to soar in Q-4. To reiterate, if firms don't use Q-3 earnings season to effectively guide Q-4 expectations lower, the stock markets will face a significant hurdle for the start of 2020 that will increase the likelihood for widespread investor disappointment.

During this time of heightened political, economic and financial market uncertainty, we believe that it is prudent to emphasize capital preservation and to be more cautious on increasing exposure to corporate credit and equities as we wait for more clarity and better timing to take advantage of future investment opportunities as they present themselves. Please do not hesitate to call our office anytime to discuss your portfolio investment strategy.

The CFO Capital Management Team
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